The Systemic Nature of the Rise in Inequality in Developed Economies¹

Pascal Petit²

Abstract
The rise in inequality in the last two decades has affected most developed economies. The systemic nature of this inequality is the focus of this paper. A combination of product market internationalization, financial globalization and technological changes favoring large organizations created asymmetric pressure on the two ends of the distribution of market incomes, resulting in greatly increased inequality. A widespread credo of political liberalism prevented governments from using taxes and transfers to check this rise in income inequality. Changes in relative prices and borrowing facilities brought some support to the standards of living of low-income groups but also contributed to increased instability of these economies. The global financial crisis was one of the possible crisis scenarios that rising inequality was bound to produce. The paper assesses the cumulative factors behind the rise in inequality. These factors reduce the capacity of industrial economies to face the challenges of ever-changing environments.

Résumé
Lors des deux dernières décennies les inégalités se sont accrues dans la plupart des économies développées. L’objet du présent article est de montrer le caractère systémique de cette évolution. La combinaison de l’internationalisation des marchés, de la globalisation financière et de changements technologiques favorisant les grandes organisations ont affecté de façon dissymétrique les deux extrémités de la distribution des revenus, aboutissant à une forte croissance des inégalités. Une adhésion nouvelle et très répandue au libéralisme économique a empêché les gouvernements d’utiliser les taxes et les transferts pour corriger cet accroissement des inégalités revenu. L’évolution des prix relatifs de nombreux imports et de plus grandes facilités d’emprunt contribuèrent néanmoins à défendre pour un temps les conditions de vie des bas revenus. Mais tout cela conduisit à augmenter l’instabilité des économies en question. Une crise financière globale était l’une des possibilités de crise provoquée par la montée croissante des inégalités. Cet article présente l’enchaînement des facteurs à l’origine de la crise. Ces facteurs réduisent par ailleurs la capacité des économies concernées à faire face aux défis environnementaux.

Nomenclature JEL : D31,E64,H23,J31,P51

Key words : inequality, distribution, growth system, political liberalism

¹Paper to be published in a special issue of International Review of Applied Economics 2010
²Pascal.Petit@univ-paris13.fr CEPN / CNRS /CEPREMAP
Introduction

The rise in inequality in the last two decades has affected most developed economies. Product markets globalization and diffusion of new technologies have often been invoked at the origin of this rise. Two aspects of these processes have been especially invoked, namely the globalization of financial markets and the organisational innovations tied with the development of information and communication technologies (ICTs). Both of these led to a continuous restructuring of production processes and put direct pressures on the market determination of wages and profits. These changes coincided with changes in the structure of taxes and benefits. In turn these changes in net incomes induced transformations of patterns of consumption and investment. All of which gave a systemic dimension to the rise in inequality. We document this systemic dynamic by looking at the diverse trajectories of OECD countries over the last two decades. Still, our perspective is not deterministic. If most OECD countries are affected, it is not to the same extent. National institutional fabrics seem to matter. Whether active policies, in given institutional contexts, can slow down, stop or reverse this rise in inequality is central to our inquiry. To address this issue, one needs first to specify the interlinked factors that are fueling the trends in inequality. The causation scheme we retain is largely built on some stylized facts, chiefly observed in the US. It investigates the impacts of the structural changes mentioned above on the generation and on the distribution of productivity gains as well as on the ensuing patterns of consumption and of investment.

We start in section 1 assessing the main traits of this reference scheme. In section 2 we return to the debate on the downwards effect of internationalization and technology on the wages of low skilled workers in developed economies. Section 3 focuses on wage formation for high-skilled workers. Section 4 will take an overall view of the political will and policies aiming to correct this inequality trend, and in section 5 will address the question of why there was so much political accommodation of this trend in democratic countries. Rising indebtedness and
shifts in relative prices helped lower income groups to maintain standards of living. Section 6 will take a comparative approach and discuss the sustainability of this trend in democratic countries with different fairness conventions. Section 7 will conclude looking at the impact of the burst of the financial crisis.

I. On changes in growth and inequality in developed economies in the 1990s and 2000s: a reference scheme.

The golden years of capitalism (1945-1975) have the reputation of having been years of compression of inequality, even if levels of inequality remained quite different among developed economies. The post-war Keynesian convention, e.g. the drive to invent some “modern” capitalism, where government interventions would care for growth and employment, accounts to some extent for this compression trend. The last two decades have been marked by a reverse trend -- increasing inequality. The ideology of free markets and deregulation that developed in the 1980s does not imply on a priori grounds a general rise in inequality. On the contrary, it emerged along with a general quest for equal individual chances and meritocratic compensation that did not imply or legitimate rising inequality.

We explain this drift as stemming from the combination of various mechanisms, tied to the form of internationalization and the nature of technological change. Let us first consider the evolutions of income inequality in OECD countries. A recent balance sheet on contemporary changes in inequality showed that between 1985 and 2005 the Gini coefficients of the distributions of market income and of total income (i.e. after tax and transfers) respectively increased by some 14% and 8% (OECD 2008). For sure, this average veils different trends in income inequality across countries and sub-periods. In table 1, for instance, we can see that the rise in inequality has been more pronounced in market economies than in coordinated economies.

But if market economies tend to have higher levels of inequality from the start of the period onwards, increases of various magnitudes are found across the developed economies, notwithstanding their degree of market coordination. Thus similar rises in inequality (Gini

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1 We retain here the dichotomous approach of the diversity of capitalism exposed by Hall and Soskice (2001), where market economies are mainly the anglo-saxon countries and coordinated economies the countries of the central and north of continental Europe.
coefficients) are observed in Norway, in Japan in Germany in Portugal and in the US, countries representing all the varieties of capitalism (see Table 1).

**Table 1**

<table>
<thead>
<tr>
<th>Summary of changes in income inequality</th>
<th>Mid-1980s to mid-1990s</th>
<th>Mid-1990s to mid-2000s</th>
<th>Mid-1980s to mid-2000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Trends in income inequality (Gini coefficients)</td>
<td>Czech Republic, Italy, Mexico, New Zealand, Portugal, Turkey, United Kingdom</td>
<td>Canada, Finland, Germany</td>
<td>Finland, New Zealand</td>
</tr>
<tr>
<td>Significant increase</td>
<td>Belgium, Finland, Germany, Hungary, Japan, Luxembourg, Netherlands, Norway, Sweden, United States</td>
<td>Austria, Denmark, Japan, Norway, Sweden, United States</td>
<td>Canada, Germany, Italy, Japan, Norway, Portugal, Sweden, United States</td>
</tr>
<tr>
<td>Small increase</td>
<td>Austria, Canada, Denmark, Greece, Ireland</td>
<td>Australia, Belgium, Czech Republic, France, Hungary, Italy, Luxembourg, New Zealand, Portugal, Spain, Switzerland</td>
<td>Austria, Belgium, Czech Republic, Denmark, France, Greece, Hungary, Ireland, Luxembourg, Mexico, Netherlands, Spain, Turkey, United Kingdom</td>
</tr>
<tr>
<td>No change</td>
<td></td>
<td></td>
<td>Austria, Belgium, Czech Republic, Denmark, France, Greece, Hungary, Ireland, Luxembourg, Mexico, Netherlands, Spain, Turkey, United Kingdom</td>
</tr>
<tr>
<td>Small decrease</td>
<td>Greece, Ireland, Netherlands, United Kingdom</td>
<td>France, Ireland, Spain</td>
<td></td>
</tr>
<tr>
<td>Significant decrease</td>
<td>France, Spain</td>
<td>Mexico, Turkey</td>
<td></td>
</tr>
</tbody>
</table>

Source: OECD (2008)

This rise in inequality over the last two decades is not uniform, however. There was a first wave of inequality increase in the mid 1980s and then a second one in the mid to late 1990s (at least for the US), and then a third in the mid-2000s.

Such medium-term increases could be transitory and associated with, as Kuznets (1955) hypothesized, an acceleration of economic growth, tied with a technological or organizational opportunity that entrepreneurs seized, soon to be followed by a widespread catching up of the other economic agents, bringing back the distribution somehow to its initial level. The long trend of rising inequality in developed OECD economies, however, does not fit with this Kuznets cycle. Not only did the rise in inequality maintain itself over a long period of time, but the two decades under view were not periods of particularly high productivity growth. On the contrary, they correspond to periods where measured productivity gains at national levels
had become minimal, following the combined effect of an increasing globalization of production processes (blurring the contribution of national industries in real terms) and the growing difficulty to measure real output when intangibles, tied with the development of ICTs, are more important generally production chains.

The point is that the catching-up mechanism in the Kuznets cycle largely relied on the capacity of wage earners in leading manufacturing sectors to claim their share of the productivity gains, soon followed by wage claims from other sectors. Once this productivity-sharing mechanism ceases to function, the mechanism of catching up becomes uncertain.

The major structural changes of the period, namely internationalization and the organizational innovation, were both brought on by the development of information and communication technologies, as well as the general increasing role of services in the economies under consideration. These changes did not offer the same possibility of catching up as was possible in earlier eras. Perhaps for this reason, wage bargaining has shifted from collective forms to a more individualized criteria which accounts for a specific function’s contribution to profitability, a process facilitated by new information technologies. This crude trend of “financialisation” at shop floor level (as reflected in more individualized wage formation, by increasing practices of individual premiums and bonuses) was strongly supported by a globalization of finance which gave more bargaining power to share holders and pressed the governance of firms in their favor.

In such a financialised world, no feedback process emerged to correct the rise in inequality in the distribution of market wages. Individual reward provides a good incentive; rising inequality means more rich people, which is seen (rightly or wrongly) as spurring more investment, and thus more growth and employment in the future. The fate of those groups that get poorer is largely ignored or partly hidden.

Countries certainly differ in terms of the relation between financialisation and wage bargaining, but not radically so, meaning that in all of them getting richer has been encouraged as something good for the community as a whole, while much less attention was given to the social cost of rising poverty among working people. For sure, countries initially

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2 See the debate on the so-called productivity paradox, as reviewed in Petit and Soete (2001).
3 Griliches (1994) stresses that the measure in real terms of over 50% of GDP components were, by the mid-1990’s, quite uncertain.
4 Another reason could be the change in the process of innovation itself which at the same time became more collective, implying different firms and thereby different entrepreneurs (see the debates on the rise of open innovation cases).
5 Also qualified of shareholder value governance.
less unequal seem to have cared more about correcting the rise in inequality, but they nonetheless allowed net increases in inequality in the distribution of net incomes to occur (e.g. Sweden and Finland).

The fact that redistribution policies did not check the rise in inequality in the distribution of market incomes has a political dimension that one can see in the orientation of fiscal policies. Since the early 1980s, a reduction of the fiscal levy, in particular on the rich, has been a leitmotiv of policies, following the threat of moving capital abroad, thanks to a globalized finance.

Other factors had a facilitating role in the process. In the first place easier access to debt enabled consumers to soften the blow of a stagnation or reduction in market incomes. Second, the consumer surplus associated with cheap imports has been a means to partly keep up with past consumption norms despite a decrease in net income. Third, the creation of new lending facilities also gave access to poor and near-insolvent households to homes and durable goods (e.g. subprime mortgage loans).

All these facilities to accommodate rising income inequality have been observed across the developed countries. The overall picture is one of societies adjusting to higher inequality levels and lowering their efforts to counter this trend. The US, which has levels of inequality closer to developing countries like Mexico and Turkey than to its European partners, figures prominently in this group.

This diffusion of inequality can also be seen in the rising inequality of access to some major services like health and education, showing how general and systemic is the inequality feature of contemporary growth regimes.

Figure 1 summarizes the cumulative causalities that define a growth regime with high levels of inequality. First is the impact on the distribution of market incomes of the skill bias nature of both (a) the form of internationalization (competition of low wage countries and financial mobility are putting under pressure the wage formation of low skilled workers), and (b) the nature of technical change (ICTs allow new division of tasks which enlarges the scope chiefly for medium and high skilled workers while it reduces it for low skill workers)\(^6\) Second, one has to add the specific effect induced by the internationalization of finance, fueling a financialisation of firm governance, boosting market incomes of CEOs and professionals of the finance industry. Third is the fact that the redistributive effect of taxes and transfers did not play their corrective role. The political pressure to reduce the tax levy seemed on the

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\(^6\) In effect the debate around the skill bias nature of technical change tends to conclude that this effect cannot be disentangled from the one induced by the form of internationalization.
contrary ready to contribute positively to the increase in income inequality. Fourth is the development of factors accommodating the rises in inequality in providing ways to cope with decreases in purchasing power like (a) increasing indebtedness of households, with new (risky) lending schemes (poverty business), and (b) giving access to cheap imports (brought by imports from low wage countries).

The combination of all the above factors re-enforces their impacts: the skill biased nature of internationalization and technological changes, the retreat of the state of various social schemes, and the necessity of cheap imports and continuous “innovation” in the poverty business. The sustainability of these processes is, however, questionable. In the first place a continuous rise in income inequality can lead in democratic societies to a political reversal in favor of strongly redistributive policies. Second, a fiscal crisis can force drastic increases in tax rates. Third, excessive household indebtedness can provoke a financial crisis. We shall hereafter come back on the various factors at work to approach this question.

Figure 1
The successive steps of a cumulative, skill-biased growth pattern

<table>
<thead>
<tr>
<th>Information and Communication Technologies</th>
<th>Distribution of market incomes</th>
<th>Distribution of net incomes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Globalisation of finance</td>
<td>Transfers and Income taxes</td>
<td>Governmental rulings</td>
</tr>
<tr>
<td>Globalisation of other product markets</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Loans to consumers...of which housing loans**

**Import prices of consumer goods**

**Public services**

**Distribution of household wealth and human capital**

**Distribution of living standards**
Note that Figure 1 does not account for changes in household activities. Indeed, families and relatives can be a source of solidarity that reduces the exclusionary effects of rising income inequality. The fact is that these familial solidarities tend to decrease in developed economies. Thus Putnam (2000) argues that in the US levels of social capital seem to have decreased in the last two decades, adding to the deprivation of the new poor. In sum, our analysis of the adjustment to higher levels of inequality involves changes in the relation among the three spheres of activities, namely the economic sphere, the political and the domestic sphere. This broad perspective is useful in assessing the relative sustainability of the various trajectories.

II. Are your wages set in Beijing? Downward pressure on the wages of low-skilled workers

In a debate on the downwards pressure on wages of low-skilled workers from growing trade with low-wage, developing countries, Freeman (1995) argued that this effect was moderate. In the first place, estimation showed only minor impacts. Second, the threat was limited to one-fifth of the labor force. Most workers in developed countries were unaffected. Third, what was happening in the US was in great contrast with Europe. The flexibility of US labor market institutions and therefore of wage bargaining led to a marked downward pressure on wages of low-skilled workers, while in Europe more binding labor institutions strongly limited this downwards trend on low-skill wages but instead led to increases in unemployment among low-skill European workers. But a decade or so after Freeman(1995)’s assessment, such a trade-off between flexibility and unemployment showed its limits: long-term unemployment increased in most European countries along with greater flexibility of labor markets (see section 5 below).

Freeman(1995) was right in contending that there was no strong evidence of factor price equalization in North-South trade. Wages in developing countries are so low compared with those in OECD countries that workers in these countries can by no means satisfy their basic needs with them. Even the working poor, a growing category of regular workers that cannot meet some basic needs, in particular housing, receive incomes well above the average income levels in China or India. But even without such equalization forces, pressure on wages has increased as firms increasingly give full priority in profit sharing to shareholders.

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7 The comparison of low-skilled worker wages in McDonald restaurants around the world is very telling of the remaining differences in 2000: hourly wages rates varied from $0.30 in India, $0.40 in China, up to $5.80 in France, or $6.90 in the UK and $6.50 in the US. Source: see the Big Mac Index published yearly by The Economist.
Freeman (1995) is also right when stressing that trade is not the only culprit. Technological change, being much centered around ICTs, plays a role in facilitating both a new segmentation between high-skill and low-skill tasks as well as a relocation of jobs. The effects of trade and of technological change are difficult to disentangle. By and large technological change and internationalization seem to account each for one third of the increase in the average skill bias (see Petit and Soete, 2001).

Wage bargaining processes in the services industries have also been affected. As noted above, wage formation in services was largely based on those in manufacturing industries and their weakening spread to all sectors. Other sectors such as financial and business services could have taken over this leadership role in wage setting, but those sectors were precisely the ones most influenced by the new rules (based on individualized merits and financial returns) and the influence of these services sectors fueled an increase in inequality than supported by collective dynamics. The rise of North-South trade in the last decade, especially with China, brought further downward pressure on the wages of low-skilled workers across all sectors. This pressure largely accounts for a major universal feature of the present state of market income distribution: the stagnation of wages of the low-skill workers (see papers by Madrick and Papanikolau, and by Howell and Okatenko in this issue).

III. Are your wages set in New York? Upward pressure on wage formation of high-skilled, white-collar workers

In contrast with downward pressure on low-skill wages, internationalization and financial globalization have had an upwards effect on the wages of highly-qualified professionals in industrialized countries. This is particularly evident in rise in CEOs pay which started in the mid-1980s (see Table 2). The trend can clearly be linked with the diffusion of a model of governance based on shareholder value among large international firms. This diffusion sets norms of references at a world level for the wages of high executives. These wages became signals for analysts and others on stocks values, giving good reasons for CEOs to seek to keep up with the best paid CEOs, generally those based in the US. Auditing and business services, as firm advisers, played a great role in spreading these new norms. Financial firms also helped being the first to diffuse the new norms. The debate in Europe over CEO pay showed

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8 China’s exports went from 0.8% of world exports of manufactures in 1980, to 1.9% in 1990 to 4.7% in 2000 and 7.3% in 2003. The Chinese share of US manufacturing imports doubled between 1995 (7.6%) and 2003 (15.9%).
that the argument of keeping up with their US colleagues to support the values of the stocks was a major reason put forward.  

Table 2

Source: supplementary chart from Abowd and Kaplan (1999)

Looking at the case of the rise of the wages of the US CEOs, which are setting the norms internationally, does not validate the hypothesis of a small labor market of specific qualifications. Bebchuk and Grinstein (2005) have analysed the wages of the top five executives of large samples of big firms. They show that their share of the wage bill roughly doubled between 1993-95 and 2000-02 and that this rise could not be explained by any standard economic factor (e.g., rate of return on investment or market share).

This rise in wages of high executives extended to other financial advantages, in the forms of stock options, golden handshakes and other special bonuses.

9 For the case of France an interview of Mr Zacharias, the CEO of VINCI, a construction firm, who received a scandalous golden handshake, explaining in Le Monde that the factor that accelerated the rise in France was more the law on transparency in 2001 than the alleged existence of a specific small labour market of highly qualified CEOs. He noticed that very few, if any, CEOs leaving their firms with golden handshake were rehired by other firms. No other claim was put forward to explain that the yearly wages of the French CEOs of the CAC40 range in 2006 between 4 millions euros (LVMH) to 400000 euros GDF.
How can we explain the behavior of CEOs, which differs so strongly from that of their predecessors of the era of “modern capitalism” as described in Galbraith (1967) where managers aimed at a cohesive managerial structure, operating within a narrow wage hierarchy (around ten times the average blue-collar wage. The same ratio now is around 500).

Many forces could have countered such a trend, including workers and shareholders. Both low-skilled workers whose wages are pressed downwards, and high-skilled workers (including some managers) who do not share in the extraordinary increase in compensation of a few high executives have shown less loyalty to the firm but have not expressed any organized response. Another factor that could have checked such an extraordinary rise in wages and financial advantages of top executives is the very interest of shareholders, put forward in the new model of governance. Indeed, it is part of their profit share which is directly diminished with the rise in executive compensation. Small shareholders do protest, feeling cheated in many cases, but they have not been able to stop this trend, which shows that shareholder value governance largely favors an international “oligopoly” of large actors on stock markets. In this more or less informal network, financial institutions and their advisers and auditors are playing a major role in establishing executive pay norms.

A third factor that could have helped to limit the rent seeking of high executives is the opposition of the political class, baffled by levels of incomes of executives that cannot be legitimized in democracies claiming that reward be linked to effort. The financial crisis of 2008 has shown the limits of political power to cut down bonuses in the financial industry, even though these same politicians acknowledge that irresponsible risk taking by this industry led to the crisis.

Conversely, one can ask why the international group of executives in question stuck so strongly to such highly criticized rent-seeking behavior. In major financial centers like New York and London, traders received bonuses in accordance with the profits they made for their firms. With stock markets activity steadily increasing, this led to enormous incomes for these professionals, inducing executives to attribute to themselves wages and bonuses of similar order of magnitude. It changed the view of the hierarchy of incomes that the whole industry had. And it spread to other trades. Wage earners have been interested in the profits they

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10 But one should not think that these extras are the cause of the rise in income of CEOs. Dew Becker and Gordon (2006, p43) showed that the phenomenon stems from the wage distribution of top earners’ income (the highest 5%). Kopczuk and Saez (2004) made a similar observation: the rise at the very top (0.01 percent richest) mainly comes from wages.

11 Even when attributions have been fraudulent as in the cases of anti-dating stock options.
generate and this new philosophy tended to diffuse across societies as a whole. The best example is given by the wages and income of athletes, which are also sometimes put forward to justify the extravagant wages of CEOs. Indeed, Tiger Woods makes even more money than any of the CEOs under criticism. Still the rule of the game for athletes is quite clear: they can claim and gain a certain percentage of what their value is for the media, which is itself function of their reputation and attractiveness. How this market value is constructed, mixing talents and commercial strategies of the medias themselves is a more complex story. More generally, in the world of entertainment, from sports to cinema and art, one observes a similar alignment of income generation practices in European countries with US practices—more Hollywood than New York in this case. A specific pattern of income formation can be observed with a high concentration on a few number of world artists. Because media (and transparency) are playing a specific role in this valuation, it leads to cumulative phenomena whereby, at some point, fame calls for fame, and high price for higher pricing, ending up with “winner take all” system (see Sherwin, 1981). Reputation, in that respect, is a form of capital open to speculation, a form of capital largely dealt with by professional managers organizing and controlling the market under view.

For CEOs there is not such a market value as we have for artists or athletes. CEOs are very seldom transferred from one firm to another, for one thing. They can build up some reputation effect, partly by the media, partly by academics, but it never reaches a point where it could be the basis governing their income formation. What we see more is how they use their power and overlapping interests on various boards to allocate these extravagant financial rewards, which they see as justified from a meritocratic perspective, taking into account their academic background and power position. This occurs in an overall climate favorable to profit sharing for all those wage earners who can claim to generate extra profit for their employer. I should add that the academic world in the US and in Europe is more and more affected by this internationalization of the market of academic talents in all fields. Altogether with the coup de force of the CEOs on a global scale, it tends to affect the formation of income of an internationalized elite all over the world. This, in turn, gives some support to CEOs in their claim and points at the fact that the elite group affected by this internationalization in income formation may concern the entire class of what Reich (1992)

\[12\] See Noll (2007).
[13] Note the role of The Harvard Business Review in praising Enron’s innovative CEO. See also studies struggling to find an efficient market of CEOs, e.g. Landier et al. (2008).
called the “symbolic workers” who can develop and value at global level their professional strategy.

One last question is whether this emerging trend can account for the effective rise in inequality that has been estimated with the increase in Ginis coefficients over the last two decades. Indeed the incomes in question are so enormous that they do impact on measures of income inequality, even if the number of highly qualified wage earners concerned is small. There is evidence that it has become a significant figure\textsuperscript{14}. Looking at changes in household income distribution in the US (at a time when stock prices were not booming) supports the idea that the rise in top wages (top 5%) played a significant role\textsuperscript{15}

To conclude, we have observed world-wide a significant upwards shift in wages of some highly qualified professionals. It may come in part from market values and in part from rent-taking positions taken by some individuals. It has been highly discussed and criticized in most countries, even by shareholders and politicians, but it has not been brought under control, being supported by highly internationalized industries such as finance and entertainment.

Beyond the rise in CEOs pays one finds a major universal feature in the distribution of income in our modern internationalized economies: those who are in position or can build a position enabling them to claim some share of some specific financial resource act as rentiers with little concern for other stakeholders. It is left to the governments to correct these primary predations by means of taxes and transfers, that is, if they want and if they can in the highly internationalized contemporary economic environment.

**IV. Are government policies aimed at correcting the inequality trend in market income distribution?**

Government policies could counter the inequality trend in the market income distribution of wages. Beyond the direct effects that income taxes and social transfers can have, labor market policies can also reduce these inequalities by fixing minimum wages and by stabilizing wage income by limiting unemployment risks. We stressed in section 2 that the distribution of net disposable income (i.e. income after direct taxes and transfers) has itself been marked by a

\textsuperscript{14} For instance the finance sector in the city of London employed in 2008 up to 200000 foreign professionals, with a wage mass equivalent to the GDP of the Luxembourg.

\textsuperscript{15} The share of after-tax national income going to the top one percent of households more than doubled between 1979 (when it stood at 7.5%) and 2005 (when it reached 15.6%), according to the Congressional Budget Office (2007).
rise in inequality. Note that transfers may vary automatically as unemployment and poverty rise, even if policy reforms have tried to severely limit this increase. Nevertheless, if transfers as percentage of GDP rose in some countries up to the mid-1980s, this trend changed just afterward. The rise in inequality in the market distribution of incomes has not been reversed by increased transfers. On the contrary in some countries this inequality has been re-enforced (see Table 3). These restrictive policies can be associated with a shift in orientation, from welfare (solidarity) to workfare (incentives) objectives.

Table 3

Changes in income inequality, OECD countries, 1985-2000
Impacts on the various components of market income and disposable income

<table>
<thead>
<tr>
<th></th>
<th>Disposable income</th>
<th>Wage Income</th>
<th>Capital Income</th>
<th>Social Transfers</th>
<th>Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Low Mid High</td>
<td>Low Mid High</td>
<td>Low Mid High</td>
<td>Low Mid High</td>
<td>Low Mid High</td>
</tr>
<tr>
<td>Level in 2000</td>
<td>8 55 37</td>
<td>5 56 40</td>
<td>7 40 53</td>
<td>30 56 14</td>
<td>4 49 47</td>
</tr>
<tr>
<td>Change from 1985-2000</td>
<td>-0.8 -1.0 1.9</td>
<td>-0.9 -1.3 2.1</td>
<td>-2.4 -3.8 6.2</td>
<td>1.3 -0.7 -0.6</td>
<td>-1.3 -3.1 4.4</td>
</tr>
</tbody>
</table>

Source: OECD 2008

The trend reversal is even clearer when looking at taxes. The reduction of taxes has been given full priority by conservative governments and associates from the early 1980s onward, following the wave of economic liberalism aimed at countering the welfare state practices of the three post-War decades. It led not only to an universal reduction in the progressiveness of income taxes (reduction of the top rates) but also to a tighter control over public spending, with rising claims of tax payers wishing to get their money back, one way or another.

Not only have transfers in general become more conditional, but the tax rates on the wealthiest have been reduced, and well-off taxpayers have successfully pressed for a rerouting of public spending to serve their own interests. Some claims in favor of small businesses are very telling in that respect of this philosophy of “I want my money back” (as stressed in Baker (2006) with what he calls the “conservative nanny state”).

Have the changes in labor market legislation been more helping in reducing the rise in market income inequality? Indeed the liberal wave of the early 1980s also gave full priority to the flexibilization of labor markets. It meant clearly, for the advocates of free markets, full-fledged deregulation of labor markets across all OECD countries, in order to reduce costs of
hiring and firing and to lower the constraints that minimum wages or legal duration of work could represent. In some countries this move to greater labor market flexibility has come with an updating of regulations, giving more security to workers in between jobs to facilitate their mobility. The Danish flexicurity system is the best example of such alternative.\textsuperscript{16} Although the issue was more open, the changes in labor market legislation appear to have been in the end rather biased against low skill workers.

Countries started from quite different regulatory situations. Changes in labor market legislation in the 1980s and 1990s did increase flexibility across the board of OECD countries (see the OECD indicator of employment protection legislation in Table 4). But an important common trait is that these changes affected more low-skilled populations than others. Very telling in this respect is the fact that employment protection legislation of regular employment did not change much while much of the adjustment occurred in temporary employment (see Table 4).

Our brief overview that we just made in this section shows that beyond the rise in inequality of market income distribution, social and fiscal policies also underwent drastic re-orientation, reinforcing rather than opposing the inequality trend in the formation of market incomes.

If the inequality trend is driven by such a wide range of elements, the question is how such a growth pattern can be sustained in democratic societies?

\textsuperscript{16} But any generalisation of such model has its shortcomings (see Keune and Jepsen, 2007).
V. On sustainability

The rise in inequality in income distribution can be more or less politically sustainable in democratic societies. We shall take a simple view of sustainability, assuming that a rise in inequality is more politically sustainable as the rate of economic growth is higher and allows standards of living of all to be increased or maintained. It is surely a simplifying assumption, as political expectations and votes take into account relative income changes as well as absolute changes in well being.

Adding to the complexity of assessing sustainability in the face of diverse structures of income inequality is the fact that many factors can contribute to accommodate a rise in inequality in increasing the current well-being of citizens. Thus downwards changes in prices can increase purchasing power and more comprehensive and subsidized public services improve well-being.

In sum, one has to include in the conditions the sustainability of these sources, and this leads us to distinguish three major sources of un-sustainability:
(1) A drastic political swing of low- and middle-classes provoked by continuously rising inequality and poverty;
(2) A major default provoked by excessive calls on one or several facilitating mechanisms
(3) A failure of governments to face major challenges in health, education or environment, provoked by a general retreat of the state.

These three types of crisis are likely to have different timing and to involve different actors. The risks also differ across countries. We shall assess in broad terms the overall likelihood of these various risks in order to show the systemic and universal nature of the inequality trend. The next section will then consider the implications of a different composition of risks operating in different countries.

Assessing risk (1)

The political sustainability of a rise in inequality depends greatly on the overall rate of growth of the economy. If the lowest incomes grow then there is a smaller likelihood of political resistance than if there is stagnation or decline of low and middle incomes. The period under consideration (1985-2005) has been one of slow growth by historical standards, at least for most European countries. It has been a period of rising rates of poverty rates (see table 5), a context that should make most countries more responsive to increases in inequality. Initial levels of inequality and the status of inequality and fairness in each society may also have their part in determining the reaction of voters. There is certainly a growing worry over rising inequality, especially fueled by the excess of financial rewards of high executive, and especially in financial institutions. The 2008 global financial crisis certainly reinforced this popular sentiment against the high salaries. But the diffusion of “luxury fever” (see Franck (1999) among top deciles of the income distribution has tended to divide the citizens and reduce the protest against inequality.

So even if the macroeconomic situation provides a source of political instability (see Irvin, 2007), much remains conditioned by the various accommodating factors in use that soften the blow and divide the electorate.

17 Notions of fairness do differ among countries, for example between the US “rags to riches” story to the egalitarian spirit of post-1930 Scandinavia. These conventions can evolve (and the Scandinavian convention has already shifted over the last decade), but one has to take them into account in assessing chances for political change.
Table 5
Trends in income poverty over the 1990’s
(poverty head-count rate at the 50% median-income threshold)

<table>
<thead>
<tr>
<th>Change in Poverty Head-Count</th>
<th>Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significant increase</td>
<td>Austria, Germany, Ireland, Japan, Netherlands, New Zealand</td>
</tr>
<tr>
<td>(more than 3 points headcount)</td>
<td></td>
</tr>
<tr>
<td>Small increase</td>
<td>Canada, Czech Republic, Italy, Luxembourg, Sweden, Turkey, United Kingdom</td>
</tr>
<tr>
<td>(between 1 and 3 headcount)</td>
<td></td>
</tr>
<tr>
<td>No change</td>
<td>Denmark, France, Greece, Hungary, Norway, Portugal, Spain, United States</td>
</tr>
<tr>
<td>(less than a headcount)</td>
<td></td>
</tr>
<tr>
<td>Small decrease</td>
<td>Mexico</td>
</tr>
<tr>
<td>((between 1 and 3 headcount)</td>
<td></td>
</tr>
<tr>
<td>Significant decrease</td>
<td>Belgium</td>
</tr>
<tr>
<td>(more than 3 points headcount)</td>
<td></td>
</tr>
</tbody>
</table>

Source: OECD (2008)

Assessing risk (2)

A major facilitator, helping consumers to cope with stagnation or reduction in income, has been the new debt possibilities opened up by the development of financial systems. Between 1985 and 2005 the levels of household debts increased substantially (see Table 6). A major share of this rise in borrowing has been linked to financing of housing.

Table 6
Household Debt, selected countries, 1994-2006
(% of disposable income)

Sources: Datastream, IXIS CIB
The importance of Chinese imports for the US consumers has been often underlined. This consumer surplus differs strongly among countries: on average per inhabitant it amounted in the mid 2000s to 1800$ for the US, 1400$ for Japan, 800$ for the UK, 500$ for France, and 400$ for Germany (CEPII, 2007).\textsuperscript{18} There is of course a risk of unsustainable trade deficits\textsuperscript{19}. One should add family support as another cushion against income declines. Indeed, help from the family is one source of solidarity that is mobilized to various extents in different countries\textsuperscript{20}. But this kind of support has universally tended to decline in the last decades, as a consequence of a greater individualization and a reduction in the size of the family circle. Part of the development of this poverty businesses (especially around car financing) appears as a substitute for reduced family lending.

\textit{Assessing risk (3)}

Extension of public (or subsidized) services could also appear as a welcome compensation for reduced market income. Greater public coverage of health or education expenditures would be obvious areas for an increased public role. Still, the universal drive for a retreat of the state has limited movement in that direction. When tax revenues cannot be raised even when poverty is increasing, there will inevitably be a downgrading of public services. This can create a downward spiral in public services that risk a social breakdown. All three risks reviewed above have risen over the last decades, rendering the rise in inequality less and less bearable for voters in democratic societies. The financial crisis that exploded in 2008 does not stem directly from the rise in inequality but its intensity and how to get out of it clearly depends on the specific risk structure of countries.

\textbf{VI. Facing the financial crisis}

What we have stressed so far is that wages have evolved in a very biased way, affecting relatively downwards the wages of low-skilled workers and upwards those of a few high-skilled professional workers and executives. This trend seems to have been quite widespread in developed economies; implying that it was largely linked with two major transformations undergone by these countries in the last decade, namely an internationalization, born by a

\textsuperscript{18} See also Baker and Rosnick (2007) for estimations of such effects of changes in relative prices.

\textsuperscript{19} One of the seven US unsustainable deficits with over lending to the private sector and shift in distribution according to Godley (1999).

\textsuperscript{20} Esping Andersen (2001) thus stresses the role played by families in the welfare systems of Mediterranean countries.
globalization of finance, and a technological change, centered around information and communications technologies. This drift has not been compensated by progressive income transfers by the state, even if in this matter countries have been acting in rather different ways according to their traditions and the kind of consensus that they have developed regarding the welfare state and the formation of wages. Such a situation in democratic societies is grossly unsustainable. It threatens the basic expectation of citizens to achieve some degree of upward mobility. “To keep up with the Joneses” was a central and to some extent achievable motto of the social contract that prevailed during the “golden years” of capitalism.

A combination of lower import prices, debt accumulation, and even product differentiation, have helped to maintain low-end living standards despite reductions in net income. But these mechanisms have their own limits and may put at risk the economy as a whole, as we saw with the subprime crisis. Moreover, they deeply divide citizens on many grounds, which strongly limits the possibilities of new political arrangements that would be required in times of crisis.

The adjustments to globalization and technological change have put consumers on various trajectories, depending on their income, their education and their experiences. The worst case is that of the working poor, wage earners that cannot afford basic living conditions including proper housing. In the context such as that created by the financial crisis of 2008, where massive public intervention is required preparing a future that could meet such big challenge as the climate threat, this division is highly counter productive. The drawbacks of an increasingly “skills biased” growth pattern are becoming more and more apparent. Risky lending to households in the US acted as a detonator of the financial crisis (bound to happen one way or another given the uncontrolled globalization of finance). The greater inequality has created social divisions, reducing social solidarity to a point of limiting the capacity to mobilize recovery plans required to restore confidence and launch economies on sustainable paths. But active social cohesion is a prerequisite for mobilizing people over such broad and fundamental issues when prejudices against public intervention have been prevailing for nearly three decades. Countries that have preserved what they regard as a fair distribution of net disposable incomes do seem in a much better position than the others.

The form of public intervention is bound to matter considerably (nature and timing of projects, soundness of expertise and control). Any project will be better off if people share access to information and knowledge and this cannot be achieved with income distributions that seem unfair and induce only selfish strategic behaviors. The most encouraging sign for
any “new deal” after the lost decades of financial capitalism would be for countries to shift away from skills-biased growth regimes that has affected them all in the past two decades.

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